No. 777

In the Supreme Court of the United States

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CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 777

NORTHWEST BANCORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINION BELOW

The memorandum opinion of the Tax Court (R. 16–28) is unreported. The opinion of the Circuit Court of Appeals (R. 35–42) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 16, 1944. (R. 43.) The petition for a writ of certiorari was filed on March 10, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a contract prohibiting the payment of dividends, except stock dividends, was such a restriction upon dividend payments as to entitle the petitioner in the taxable year to the credit provided for in Section 26 (c) (1) of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are printed in the Appendix, *infra*, pp. 12–20.

STATEMENT

The facts as found by the Tax Court (R. 17–25) may be summarized as follows:

The petitioner, a Delaware corporation with principal place of business in Minneapolis, Minnesota, is engaged in the business of owning and holding shares of common stock in banks and other financial institutions and in rendering supervisory services to such banks and institutions. One of these institutions was Union Investment Company [hereinafter referred to as Union], all of whose stock was owned by petitioner. (R. 17.)

On December 30, 1933, petitioner and Union executed a written contract in consideration of a loan of $3,000,000 to Union by the Reconstruction Finance Corporation [hereinafter referred to as RFC] and the purchase by RFC of securities in banks owned by the petitioner (R. 17–18). The contract contained the provision that (R. 19):

> Fifth. Northwest Bancorporation will not, without the prior written consent of RFC, declare or pay any dividends (except stock dividends) upon any of its outstanding shares of capital stock * * *

unless and until three conditions had been fulfilled. One of the three conditions was not complied with in 1936 and 1937,[1] and RFC refused its consent to the payment of dividends in those years (R. 19–20, 22, 23).

During 1936 and 1937 the number of shares of petitioner's capital stock which were authorized was 2,000,000 and the number issued was 1,679,501. During such years the greatest and smallest numbers of shares held in petitioner's treasury at any one time were 102,066 and 92,453, respectively. The smallest number of shareholders at any one time during 1936 and 1937 was 17,660; the smallest number of shares held by any one stockholder was one share and the greatest number of shares held by any one stockholder was 15,540. Petitioner's capital stock was listed and dealt in on the Chicago Stock Exchange in 1936 and 1937. (R. 20–21.) Prior to 1932 its stock consisted of common stock of a par value of $50 per share. After October, 1932, petitioner's stock was of no par value (R. 25).

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[1] The surtax liability of petitioner for the year 1936 only is involved in this petition for certiorari. However, it was stipulated before the Circuit Court of Appeals that the right to a dividend restriction credit in 1937 would be controlled by the final decision in this case.

Petitioner's surplus per books on December 31, 1936, was \$21,550,749.11 and on December 31, 1937, was \$22,632,341.19 (R. 21). Its earnings or profits before federal income taxes were \$359,-604.15 for 1936 and \$627,492.96 for 1937 (R. 22).

Petitioner's bylaws provide that dividends on its capital stock "may be paid in cash, in property or in shares of the capital stock" (R. 22).

Petitioner paid dividends from the time of its organization until January 1, 1933. It paid no dividends from January 1, 1933, to November 25, 1939. Since the latter date it has paid dividends regularly. (R. 24.)

Upon the basis of the foregoing facts the Tax Court held that although the contract of December 30, 1933, expressly permitted the payment of stock dividends, the petitioner was entitled to a credit under Section 26 (c) (1) of the Revenue Act of 1936, because the only stock dividends which the petitioner could have paid under its existing capitalization would have been nontaxable to the stockholders (R. 25–28). The Circuit Court of Appeals reversed on the grounds that to comply with Section 26 (c) (1) the contract must prohibit the payment of dividends in all forms, including both taxable and nontaxable stock dividends; or if Section 26 (c) (1) should be construed as requiring a contractual prohibition against taxable stock dividends only, no credit was allowable in any event since a restriction on the

payment of taxable stock dividends was not found in the provisions of the written contract (R. 36–42).

ARGUMENT

In computing the surtax imposed upon a corporation by Section 14 of the Revenue Act of 1936 (Appendix, *infra*), a credit is allowed by Section 26 (c) (1) of that Act (Appendix, *infra*) of—

> An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends.

This case presents the question of whether the petitioner is entitled to such a credit by reason of its contract of December 30, 1933, which expressly permitted it to pay stock dividends.

The decision of the court below holding that Section 26 (c) (1) requires a contractual prohibition against dividends in all forms and not merely against asset distributions is in accord with *United States* v. *Dakota Tractor & Equipment Co.*, 125 F. 2d 20 (C. C. A. 8th), certiorari denied, 316 U. S. 671; *Commissioner* v. *Columbia River P. M.*, 127 F. 2d 558 (C. C. A. 9th); *Commissioner* v. *Oswego Falls Corp.*, 137 F. 2d 173 (C C. A. 2d); and *Valentine-Clark Corp.* v. *Commissioner*, 137 F. 2d 481 (C. C. A. 8th),

pending before this Court on petition for writ of certiorari, No. 644. The administrative construction of the statute is to the same effect. Article 26–2 (b) of Treasury Regulations 94 (Appendix, *infra*).

This construction of the statute is also supported by decisions of this Court that Section 26 (c) (1) grants a special credit in the nature of a deduction and must be strictly construed against the taxpayer, who has the burden of showing that its contract comes within the exact statutory provisions (*Helvering* v. *Northwest Steel Mills,* 311 U. S. 46; cf. *Helvering* v. *Ohio Leather Co.,* 317 U. S. 102).

Notwithstanding these decisions, the petitioner argues that Section 26 (c) (1) should not be construed as applying to stock dividends, or in fact to anything except asset distributions. The statute, however, is not so limited in terms and the petitioner cites no cases which would support such a construction. Instead, it relies on a statement made on the Senate floor as to a change in the provision there. The statement, however, is quite inconclusive on the question,[2] and a construc-

[2] Section 15 (a) of H. R. 12395, as introduced in the Senate, provided: "If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the taxable year without violating a provision of such contract expressly dealing with the payment of dividends," the tax should be computed in a certain manner provided it did not increase the tax which would

tion of the word "dividends" to include stock dividends would seem to be in accord with the legislative purpose in enacting the undistributed profits tax law. See *Commissioner* v. *Columbia River P. M., supra*, p. 560. Section 27 of the same Act (Appendix, *infra*) is in *pari materia*, Section 27 being designed to grant credit for dividends actually paid and Section 26 (c) (1) being designed to give a credit to corporations which could not pay dividends because of a restrictive contract. Inasmuch as Section 27 makes specific provision for dividends payable in cash, in kind, in obligations of the corporation and for taxable and nontaxable stock dividends, Congress must have intended that Section 26 (c) (1), as a complementary section, should have the same scope, particularly as there is no limiting phrase in that section.[3]

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otherwise be payable. The statement of Senator La Follette on the Senate floor that the Senate revision (which became Section 26 (c) (1) of the Revenue Act of 1936) was a more liberal provision may well be explained by the fact that the critical date for entering into contracts restricting dividends was extended to May 1, 1936. The significance of the earlier date was that it was the date on which the President sent a message proposing that a tax be levied on the undistributed profits of corporations. H. Rep. No. 2475, 74th Cong., 2d Sess., pp. 1–3 (1939-1 Cum. Bull. (Part 2) 667–669).

[3] There is no merit to the contention that a statement in S. Rep. No. 1631, 77th Cong., 2d Sess., p. 245 (1942-2 Cum. Bull. 504) referring to "sufficient assets", shows that Congress intended the term "dividends" in Section 26 (c) (1) to mean only asset distributions. Section 501 (a) of the Revenue Act of 1942 amends Section 26 of the Revenue Act of 1936 to

Alternatively, petitioner argues that if Section 26 (c) (1) be construed to apply to stock dividends, its scope should be limited to taxable stock dividends. This contention is contrary to *United States* v. *Dakota Tractor & Equipment Co., supra,* and there are no appellate court decisions in petitioner's favor.[4] Section 115 (f) (1) of the Revenue Act of 1936, which petitioner cites, does not limit the general definition of dividend in Section 115 (a) (Appendix, *infra*), but merely prescribes that stock dividends may be subject to tax in the hands of shareholders to the extent that the Constitution permits, in contrast with the language of earlier statutes providing that they should not be taxed at all. See *Helvering* v. *Griffiths,* 318 U. S. 371, 380–383; H. Rep. No. 2475, 74th Cong., 2d Sess., p. 10 (1939–1 Cum. Bull. (Part 2) 667, 674); S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 678, 690). There is nothing to indicate that the term "dividend" in Section 26 (c) (1) has any narrower meaning than the general definition of dividend set out in

provide for credits in the cases of deficit corporations prohibited by state law from paying dividends and corporations required by contract to use earnings in redemption of preferred stock. The reference in the Senate Report to "sufficient assets" relates to these new credits and has no bearing on the meaning of Section 26 (c) (1) of the Revenue Act of 1936.

[4] *Bates Valve Bag Corp.* v. *Higgins* (S. D. N. Y.), decided June 23, 1943 (1943 P–H, par. 62,734), supports the petitioner, but this case is pending on the Government's appeal before the Circuit Court of Appeals for the Second Circuit.

Section 115 (a). That the language in Section 115 (a) is broad enough to include all stock dividends is clear from *Eisner* v. *Macomber,* 252 U. S. 189.

But even if Section 26 (c) (1) be construed as petitioner contends, the decision below is correct. The petitioner's contract contains no restriction against the payment of taxable stock dividends, but on the contrary expressly permits stock dividends, taxable or otherwise, to be paid. As evidence of its inability to pay taxable stock dividends, petitioner would import into the contract its certificate of incorporation, which authorizes only one class of stock, and the general law with respect to taxability of stock dividends. But the rule is settled that the restriction must be expressly written in the executed contract and may not be pieced out by other documents, not expressly or impliedly a part of the contract (*Helvering* v. *Northwest Steel Mills, supra; Commissioner* v. *Columbia River P. M., supra*). The certificate of incorporation was not a written contract within the meaning of Section 26 (c) (1) (*Helvering* v. *Northwest Steel Mills, supra*) and it was neither expressly nor by implication incorporated in the written contract in this case.

Petitioner concedes that there is no conflict in the cases (except for the one District Court case referred to above, which has been appealed), but it indicates that there has been considerable un-

certainty in Tax Court decisions on this question and that clarification is needed. Such uncertainty would not constitute a basis for certiorari; but even if it would, the Tax Court in its latest decisions has followed the Circuit Courts of Appeals in holding that the restriction must be one effected by the contract alone and not by extrinsic conditions. Any previous vacillation on the part of the Tax Court, therefore, seems now to have been stilled. See *Kaufmann Department Stores Securities Corp.* v. *Commissioner,* 2 T. C. 656, pending on review (C. C. A. 3d); *Northwestern Steel & Wire Co.* v. *Commissioner,* 1 T. C. 1114, pending on review (C. C. A. 7th); *Oregon Pulp & Paper Co.* v. *Commissioner,* 47 B. T. A. 772.

In any event, if facts outside the contract are properly to be considered, they fail to show that the petitioner was prohibited from paying a taxable stock dividend. It had both net income and earned surplus in the taxable year which were available for transfer to capital account upon issuance of stock dividends (R. 21, 22). And although only one class of stock was authorized, under the law of Delaware (Appendix, *infra*) petitioner could have changed its capital structure to provide for other classes of stock, so that it would have been in a position to pay a taxable stock dividend. To the petitioner's suggestion that amendment of its charter might have been impracticable, it may be observed that the peti-

tioner had altered its capital structure twice before in its corporate history (R. 13–16) and further alterations would not seem to be beyond the limits of practicability. However, we submit that the provisions of the contract alone should be decisive of the issue, and that the contract here did not prohibit the distribution of stock dividends, taxable or otherwise.

CONCLUSION

The decision of the court below is correct and the petition for writ of certiorari should be denied.

Respectfully submitted.

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